JUNE – SEPTEMBER 2012

TAX TIPS & news

Tax Calendar

June 15, 2012:

- U.S. citizens living abroad on April 17, 2012 must file a 2011 Income Tax Return (if not already filed) or file for an extension.
- Second installment of 2012 Individual Estimated Taxes due. If your income or deductions have significantly changed, you should call this office to determine if any adjustment in estimates is appropriate.

June 30, 2012:

- Last day to report a financial interest in or signature or other authority over any foreign financial accounts with an aggregate value over $10,000 by filing Form TD F 90-22.1. There are no extensions and substantial penalties for failing to file. Caution: the form must be delivered to the IRS office in Detroit by the June 30 date, not just postmarked on that date.

June-July 2012:

- Time to review 2012 year-to-date income and expenses to ensure estimated tax payments and withholding are adequate to avoid underpayment penalties.

July 31, 2012:

- Due date for self-employed individuals and employers to file 5500 Series Returns for 2011 calendar year benefit plans (including Keogh/HR-10 plans).

September 17, 2012:

- Third installment of 2012 Individual Estimated Taxes due.
- Due date for calendar year partnerships and corporations that were given a 5-month extension to file beyond the April 17 due date. This is also the due date for income tax returns (Form 1041) of calendar year estates and trusts that applied for the 5-month extension to file.

Since You Asked...

You Asked: I am considering installing some energy-efficient exterior windows on my existing home, and I understand there is a tax credit for doing that. Can you provide me some details?

Answer: Unfortunately, the credit for energy-efficient home modifications expired at the end of 2011, and unless Congress extends it, you will not receive any tax benefit for the energy-efficient windows. The only energy credit remaining for homes is the residential energy-efficient credit (30%) for installation of alternative energy creation systems such as solar power, fuel cells, wind energy, etc., which is available through 2016.

You Asked: In 2010, my wife and I purchased a home, and we qualified for the first-time homebuyer credit. We have since divorced, and I got the home as part of the property settlement. How is the gain and credit recapture divided up if I sell the home in 2012?

Answer: When there is a property settlement incident to a divorce, the community tax basis is assumed by the one that retains the property. Thus, you have assumed the liability for any gain attributable to the joint ownership. In addition, the one that retains the home also assumes the liability for recapturing the new homebuyer credit if the home does not continue to be the primary residence of one of the couple for 36 months from the purchase date.

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TAX TIPS & news

This Issue Includes:

Do You Need To Make Estimated Tax Payments?

Our tax system is a "pay-as-you-go" system, and if your pre-paid amount is not enough, you become liable for non-deductible interest penalties. To facilitate that concept, the government has provided several means of assisting taxpayers in meeting the "pay-as-you-go" requirement. The primary among these include:

- Payroll withholding for employees;
- Pension withholding for retirees; and
- Estimated tax payments for self-employed individuals and those with other sources of income not covered by withholding.

Determining how much tax to pre-pay through withholding and estimated tax payments has always been difficult, but thanks to Congress' constant tinkering with the tax laws, usually in late fall, ensuring there are no underpayment penalties or tax surprises when the tax return is prepared next year merely adds complexity.

One of the biggest unknowns for 2012 is the alternative minimum tax (AMT). Beginning in 2001, the exemption to the amount of income not subject to AMT was substantially increased and inflation-adjusted in subsequent years. However, the increased exemption amounts are not permanent and must be extended by Congress on a year-by-year basis. So far Congress has not acted for 2012, and if they do not, the AMT exemption will revert to 2000 levels, roughly one-half of the current amount. Without Congressional action an estimated 30 million taxpayers, approximately 20% of all taxpayers, will be hit by the AMT in 2012. Compare this to the roughly 600,000 taxpayers in 1997 (approximately 1% of all 1997 taxpayers) who were affected by the AMT.

When a taxpayer fails to prepay a safe harbor (minimum) amount, he or she can be subject to the underpayment penalty. This penalty is the short-term federal rate plus 3 percentage points and the penalty is computed on a quarter-by-quarter basis. So, even if you pre-pay the correct amount for the year, if the amounts are not paid evenly you could be subject to a penalty. Interestingly enough, withholding amounts are treated as paid ratably throughout the year, so taxpayers who are underpaid in the earlier part of the year can compensate by bumping up their withholding in the later part of the year.

Federal tax law does provide ways to avoid the underpayment penalty. If the underpayment is less than the $1,000 de minimis amount, no penalty is assessed. In addition, the law provides "safe harbor" prepayments. There are two safe harbors:

1. The first safe harbor is based on the tax owed in the current year. If your payments equal or exceed 90% of what is owed in the current year, you can escape a penalty.
2. The second safe harbor is based on the tax owed in the immediately preceding tax year. This safe harbor is generally 100% of the prior year's tax liability. However, for a higher income taxpayer whose AGI exceeds $150,000 ($75,000 for married taxpayers filing separately), the prior year's safe harbor is 110%.

Example: Suppose your tax for the year is $10,000 and your prepayments total $5,600. The result is that you owe an additional $4,400 on your tax return. To find out if you owe a penalty, see if you meet the first safe harbor exception. Since 90% of $10,000 is $9,000, your prepayments fell short of the mark. You can't avoid the penalty under this exception.

However, in the above example, the safe harbor may still apply. Assume your prior year's tax was $5,000. Since you prepaid $5,600, which is greater than 110% of the prior year's tax (110% = $5,500), you qualify for this safe harbor and can escape the penalty.

If your state has a state tax, the safe-harbor amount may be a different percentage.

This example underscores the importance of making sure your prepayments are adequate, especially if you have a large increase in income. This is common when there is a large gain from the sale of stocks, sale of property, when large bonuses are paid, when a taxpayer retires, etc.

If you have questions regarding your pre-payments or would like to review and adjust your W-4 payroll withholding, W-4P pension withholding, and estimated tax payments to provide the desired tax result for 2012, please give this office a call.

Read This before Tossing Old Tax Records

Now that you've completed your taxes for 2011, you are probably wondering what old records can be discarded. If you are like most taxpayers, you have records from years ago that you are afraid to throw away. To determine how to proceed, it is helpful to understand why the records needed to be kept in the first place.

Generally, we keep "tax" records for two basic reasons: (1) in case the IRS or a state agency decides to question the information reported on our tax returns; and (2) to keep track of the tax basis of our capital assets so that the tax liability can be minimized when we actually dispose of the assets.

With certain exceptions, the statute for assessing additional tax is three years from the return due date or the date the return was filed, whichever is later. However, the statute of limitations for many states is one year longer than the federal. In addition to lengthened state statutes clouding the recordkeeping issue, the federal three-year assessment period is extended to six years if a taxpayer omits from gross income an amount that is more than 25% of the income reported on a tax return. And, of course, the statutes don't begin running until a return has been filed. There is no limit on the assessment period where a taxpayer files a false or fraudulent return in order to evade tax.

If an exception does not apply to you, for federal purposes, most of your tax records that are more than three years old can probably be discarded; add a year or so to that if you live in a state with a longer statute.

For example: Sue filed her 2011 tax return before the due date of April 17, 2012. She will be able to dispose of most of her records safely after April 15, 2015. On the other hand, Don files his 2011 return on June 2, 2012. He needs to keep his records at least until June 2, 2015. In both cases, the taxpayers may opt to keep their records a year or two longer if their states have a statute of limitations longer than three years. Note: If a due date falls on a Saturday, Sunday or holiday, the due date becomes the next business day.

The big problem! The problem with discarding records indiscriminately for a particular year once the statute of limitations has expired is that many taxpayers combine their normal tax records and the records needed to substantiate the basis of capital assets. They need to be separated, and the basis records should not be discarded before the statute expires for the year in which the asset is disposed. Thus, it makes more sense to keep those records separated by asset. The following are examples of records that fall into this category:

- **Stock acquisition data –** If you own stock in a corporation, keep the purchase records for at least four years after the year the stock is sold. This data will be needed in order to prove the amount of profit (or loss) you had on the sale.
- **Stock and mutual fund statements –** Many taxpayers use the dividends that they receive from a stock or mutual fund to buy more shares of the same stock or fund. The reinvested amounts add to the basis in the property and reduce gains when the stock is finally sold. Keep statements at least four years after the final sale.
- **Tangible property purchase and improvement records –** Keep records of home, investment, rental property or business property acquisitions AND related capital improvements for at least four years after the underlying property is sold.

Have questions about whether or not to retain certain records? Give this office a call first. It is better to be sure before discarding something that might be needed down the road.

Charity Purchases and Auctions

A regular form of fundraising by charitable organizations consists of sales or auctions of property or services at a price in excess of value. These are referred to as "quid pro quo" contributions or dual payments made that consist partly of a charitable gift and partly of consideration for goods or services provided to the donor.

Quid pro quo contributions typically include the purchase of tickets for sightseeing tours, all-expense-paid trips, theatrical or concert performances, books or subscriptions to magazines, stationery, candy, etc., and are sold with a generous mark-up that is designed to help the charity in performing its functions. In these cases, the charitable deduction is the excess of the payment over the value received by the purchaser-contributor. For instance, when tickets to a show are purchased from a charity at a price in excess of the normal admission charge, the excess over the latter (plus tax) is a charitable contribution.

Determining and documenting the amount of the purchase that represents the charitable portion is the key to being able to take a charitable tax deduction for quid pro quo purchases. Tax law requires charitable organizations that receive a quid pro quo contribution in excess of $75 to provide a written statement, in connection with soliciting or receiving the contribution, that informs the donor that the amount of the contribution that is deductible for federal income tax purposes is limited to the amount of the purchase that is in excess of the value of the property or service purchased and a good-faith estimate of the value of the good or services purchased.

Example #1 – A taxpayer purchases a cookbook from a charity for $100. The charity provides the taxpayer with a good faith estimate of $20 for the value of the book in a written disclosure statement. Thus, the taxpayer's charitable deduction is $80 ($100 minus the $20 value of the book).

Example #2 – A taxpayer attends a charity auction. The charity provides a catalog of the items for auction and a good-faith estimate of the value of each item. The taxpayer is the successful bidder for a vase valued at $100 in the catalog, for which the taxpayer bid and paid $500. The taxpayer's charitable deduction is $400 ($500 minus the good-faith valuation of $100).

Example #3 – A taxpayer pays $40 to see a special showing of a movie for the benefit of a qualified charity. The ticket read "Contribution $40". If the regular price for the movie is $10, the contribution would be $30 ($40 minus the regular $10 ticket price).

If you made or are considering making a quid pro quo purchase from a charitable organization and have questions relating to the amount that will represent a charitable contribution, please give this office a call.

Is Your Child a Full-Time Student?

If you have a qualified child you can claim an exemption for that child on your tax return, which results in a $3,800 deduction for 2012 (up from $3,700 in 2011). Depending upon your tax bracket, that deduction can produce a substantial tax savings. To be treated as a qualified child, a child must be under the age of 19 or a full-time student under the age of 24.

Generally, children under the age of 19 who have investment income, such as interest and dividends, are also subject to the so-called "kiddie tax," which, except for small amounts, causes the child's income to be taxed at the parent's marginal rates. The "kiddie tax" was implemented several years ago to curtail parents from shifting income to a child to take advantage of the child's lower tax rates. Full-time students under the age of 24 who are not self-supporting are also subject to the "kiddie tax" rules.

So what is the definition of a full-time student? Well, the tax law definition is more liberal than you might imagine. A full-time student is one enrolled for some part of five calendar months (whether or not consecutive) in a given year for the number of hours or courses considered full-time attendance by the school that the student is attending.

The enrollment in school needn't be for full months—or for five consecutive months. So, if the student is enrolled from mid-February to mid-June, the five-month qualification is met. On the other hand, if the student is enrolled from September to December or February to May, the student has been enrolled for only four months, and there must be full-time enrollment during at least one other month during the calendar year to meet the definition.

The full-time student designation also applies when claiming the lucrative American Opportunity Education Credit, which is based on payment of college tuition and related fees. For all but certain qualified children, claiming the credit only requires attendance for an academic period (semester, quarter, etc.). In order for parents to claim the credit for a qualified child who is over the age of 18 and under the age of 24, the qualified child must also be a full-time student.

If you have questions, please contact this office.

Are You an Employee or an Independent Contractor?

The distinction has significant implications for both the employer and the employee. Employers like to treat individuals as independent contractors because they avoid having to match the employees' payroll tax, pay benefits, pay unemployment insurance, etc. This results in a significant savings for employers.

When you are an employee, the employer pays you a net amount after making all the required tax withholdings and provides you with a W-2 for tax reporting that shows your taxable wages and details all of the withholding amounts. If you are an independent contractor, the employer will pay you a gross amount without any withholding and will issue you a 1099-MISC.

Independent contractors must pay self-employment (SE) tax instead of having FICA (Social Security and Medicare program contributions) deducted from their wages. The SE tax rate is generally twice the amount of the FICA rate. Independent contractors are generally treated the same as self-employed individuals, so the SE tax and income tax are based on their net earnings after deducting any allowable expenses incurred to earn the income.

The problem here is that employees generally do not have tax-deductible expenses related to their jobs, so employees who are incorrectly classified as independent contractors find themselves essentially paying both the employer's and their own share of the Social Security and Medicare taxes. To make matters worse, as an independent contractor, no federal or state income tax was withheld, leaving the independent contractor with a sometimes unexpected tax liability.

Classifying a worker as an employee or independent contractor is not discretionary for the employer. The employer must follow federal guidelines when making the determination. Basically, it boils down to whether the employer has direction and control over the individual, which includes, among other guidelines, specifying working hours, how to perform the work tasks, the right to fire, etc. If the employer does have direction and control, the individual is probably an employee.

If you have been treated as an independent contractor and think that you are really an employee, you do have recourse. You can file Form 8919. If the IRS agrees with you, you only have to pay the employee share of FICA/Medicare, not the self-employment tax. You still have to pay the income tax. The filing will make life miserable for your presumably former "employer," so it might turn into a bridge-burning exercise.

If you have questions, wish to explore alternatives, or need assistance filing Form 8919, please give this office a call.

Identity Theft and Tax Fraud Are Growing Problems

Cyber criminals have been using stolen identities to file tax returns and obtain fraudulent refunds. Tax preparers have reported an increase in e-file rejections because the taxpayers' or their children's SSNs have already been used in a previously e-filed return, which results in the e-filed return being rejected.

Generally, identity thieves use personal data to steal financial accounts and run up charges on the victim's existing credit cards. However, identity theft can also affect your tax records as follows:

- Undocumented workers or other individuals use your Social Security number to get a job. The employer then reports W-2 wages the workers earned under your Social Security number to the IRS. When you file your return based on your real W-2 income, it appears that you failed to report part of your income on your return.
- An identity thief files a return using your Social Security number to claim refundable credits. This can be lucrative for cyber thieves who take advantage of the Earned Income Credit or the American Opportunity Education Credit, both of which are refundable credits. Generally, credits can only be used to offset a tax liability. However, these two credits are refundable even if the taxpayer has no tax liability.
- An identity thief may also use your Social Security number or your children's SSN to claim additional tax return exemptions. Each exemption claimed on a return provides a deduction worth $3,800 (2012) and can be used to claim head of household status.

How do the thieves obtain this information? Some buy it from other thieves who collect identity information by hacking into firms that have those records or by using ingenious ways to trick you into disclosing the information. This is often done by sending you an e-mail disguised to look like an e-mail from a trusted source. This practice is referred to as "phishing." An example of phishing is an e-mail with a fake IRS header claiming to have a refund for you and directing you to a site that requires you to enter your SSN and other information to verify your claim for the refund.

Don't be a cyber-victim. Here are some tips you should know about phishing scams.

1. The IRS and legitimate businesses never ask for detailed personal and financial information such as Social Security numbers, PIN numbers, passwords or similar secret access information for credit card, bank or other financial accounts.

2. The IRS does not initiate contact with taxpayers by e-mail to request personal or financial information. If you receive an e-mail from someone claiming to be a representative of the IRS or directing you to an IRS site:

   - Do not reply to the message.
   - Do not open any attachments. Attachments may contain malicious code that will infect your computer.
   - Do not click on any links. If you clicked on links in a suspicious e-mail or phishing website and entered confidential information, you may have compromised your financial information. If you entered your credit card number, contact the credit card company for guidance. If you entered your banking information, contact the bank for the appropriate steps to take. The IRS website provides links to additional resources that can help. Visit the IRS website (www.irs.gov) and enter the search term "identity theft" for additional information.

3. The address of the official IRS website is www.irs.gov. Do not be confused, misled or respond to sites claiming to be the IRS but ending in .com, .net, .org or other designations instead of .gov.

4. If you receive a phone call, fax or letter in the mail from an individual claiming to be from the IRS, but you suspect he or she is not an IRS employee, contact this office immediately. You should also call the IRS at 1-800-829-1040 to determine if the IRS has a legitimate need to contact you. Report any bogus correspondence. You can forward a suspicious e-mail to phishing@irs.gov.

If you receive a notice or letter from the IRS or state tax authorities, you should always contact this office. This is especially true if you believe someone may have used your Social Security number fraudulently or stolen your identity.